

Audit Report



CASH IMPACT OF THE CONSUMABLE ITEM TRANSFER,
PHASE II, FY 1998

Report No. 99-072

January 27, 1999

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Department of Defense

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Acronyms

CIT	Consumable Item Transfer
DLA	Defense Logistics Agency
ICP	Inventory Control Point
PBD	Program Budget Decision



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
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January 27, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DEPUTY UNDER SECRETARY OF DEFENSE
(LOGISTICS)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE LOGISTICS AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on the Cash Impact of the Consumable Item Transfer, Phase II,
FY 1998 (Report No. 99-072)

We are providing this report for your information and use. This report is the third in a series regarding the cash impact of the Consumable Item Transfer, Phase II. The audit was requested by the Under Secretary of Defense (Comptroller), Deputy Comptroller (Program and Budget). Because this report contains no recommendations, no written comments were required and none were received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Tilghman Schraden at (703) 604-9186 (DSN 664-9186) (tschraden@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed on the inside back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the printed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 99-072
(Project No. 7LD-5038.01)

January 27, 1999

Cash Impact of the Consumable Item Transfer, Phase II, FY 1998

Executive Summary

Introduction. This audit was requested by the Under Secretary of Defense (Comptroller), Deputy Comptroller (Program and Budget). This report is the third in a series regarding the cash impact of the consumable item transfer (CIT), phase II. In July 1990, The Deputy Secretary of Defense directed the transfer of the management of consumable items from the Military Departments to the Defense Logistics Agency (DLA). The transfer process was separated into two phases. The CIT, phase I, was completed in November 1995, and phase II was scheduled for completion in FY 1998. In November 1995, the Military Departments threatened to stop the phase II transfer unless DLA agreed to reimburse the Military Departments' supply management business areas of their Defense Working Capital fund to compensate the Military Departments for the estimated lost sales revenue from phase II items. As a result, the Deputy Comptroller issued Program Budget Decision No. 425 in December 1996, which showed the potential cash impacts for the Military Departments' supply management business areas of the Defense Working Capital fund for FYs 1996 and 1997. For FY 1996, Inspector General, DoD, Report No. 97-106, "Consumable Item Transfer, Phase II, Cash Imbalance Issue," March 5, 1997, reported the reimbursements to the Military Departments at \$66.5 million. For FY 1997, Inspector General, DoD, Report No. 98-071, "Cash Impact of the Consumable Item Transfer, Phase II, FY 1997," February 11, 1998, reported the reimbursements to the Military Departments at \$229.1 million.

Objectives. The objective of this audit was to report on the cash impact that the FY 1998 CIT, phase II had on the Army, the Navy, the Air Force, and DLA supply management business areas of the Defense Working Capital fund. We also included a review of the management control program as it applied to the audit objectives.

Results. The DLA used an objective methodology to compute the reimbursement amounts for CIT, phase II. As a result of using the DLA methodology, the FY 1998 reimbursement to the Military Departments' supply management business areas of the Defense Working Capital fund was approximately \$285.1 million (see finding).

Management controls applicable to the audit objective were deemed to be adequate in that we did not identify any material management control weaknesses (see Appendix A).

Management Comments. The report made no recommendations; therefore, written comments were not required and none were received.

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Background

This report is the third in a series regarding the cash impact of the consumable item transfer (CIT), phase II. We performed the audit in response to a request from the Under Secretary of Defense (Comptroller), Deputy Comptroller (Program and Budget), concerning a cash imbalance issue for FY 1998. The cash impact for FYs 1996 and 1997 CIT, phase II, transfers is reported in Inspector General, DoD, Report No. 97-226, "Consumable Item Transfer, Phase II, Cash Imbalance Issue," March 5, 1997, and Inspector General, DoD, Report No. 98-071, "Cash Impact of the Consumable Item Transfer, Phase II, FY 1997," February 11, 1998, respectively.

Consumable Items. Consumable items are those supply items that are consumed in use or discarded when worn out or broken because they cannot be repaired economically. Consumable items include not only common usage, low-cost supplies and minor parts, such as fasteners and gasket materials, but also high-priced, sophisticated spare parts, such as microswitches; miniature components; and precision valves, that are vital to operating major weapon systems. As of December 1989, DoD managed approximately 4.1 million consumable items. Of the 4.1 million items, 2.9 million were managed by inventory control points (ICPs) of the Defense Logistics Agency (DLA) and 1.2 million were managed by ICPs of the Army, the Navy, the Air Force, and the Marine Corps.

Transfer Approval. In 1990, the Deputy Secretary of Defense approved the transfer of the management of consumable items from the Military Departments to DLA. A management team comprising representatives from the Office of the Secretary of Defense, the Military Departments, and DLA was formed to review all facets of the CIT. The management team used item management codes to develop a filter criteria to categorize consumable items that the Military Departments managed. In December 1990, the now Deputy Under Secretary of Defense (Logistics) approved the filter criteria. Consumable items were to be transferred in two phases. Phase I consisted of routine, less complex consumable supplies and spare parts. Phase II consisted of items that were more complex and sophisticated because of their design instability and unique end item and critical applications, or because they required intensive management.

Transfer Plan. The Military Departments and DLA developed a plan for the transfer of management, technical, and supply data in monthly increments. In phase I, about 760,000 items were transferred to DLA during a 4-year period that ended November 1995. In phase II, the Military Departments reviewed items to identify those that required continued Military Department management. Items not requiring Military Department management were to be transferred to DLA during CIT, phase II.

Phase II Transfer. The first increment of phase II items was transferred to DLA in January 1996. As of September 1998, the Military Departments had transferred to DLA about 140,000 of the 151,000 items planned for transfer. The phase II completion date, originally planned for September 1997, was extended to November 1998.

Cash Imbalance Issue. In November 1995, the Military Departments, concerned with the amount of anticipated lost revenues from the sale of CIT, phase II, items, informed the Deputy Under Secretary of Defense (Logistics) and the Director, DLA that they would stop the phase II transfer indefinitely. The suspension would end with a suitable resolution of the Defense Working Capital fund cash implications of the phase II transfer. In DoD, the general agreement was that the gaining DLA ICPs would experience a cash benefit from the sales of the additional items managed as a result of the CIT. Conversely, the losing Military Department ICPs would incur a related reduction in cash from the loss of sales from items transferred. In the CIT process, the losing Military Department ICP does not receive sales collections after items are transferred but continues to make disbursements for items that are on order at the time of transfer. To avoid reduced operations and readiness in the Military Departments and to ensure cash neutrality with the CIT, phase II, the Deputy Comptroller requested the Military Departments to submit estimates of the cash impact of CIT, phase II. As a result, the Military Departments submitted estimates totaling \$540.5 million (\$146.4 million for FY 1996 and \$394.1 for FY 1997). They submitted no estimates for FY 1998. We issued a draft audit report in November 1996 that verified sales and obligations for FY 1996 CIT, phase II, item transfers. Based on our draft report, the Deputy Comptroller issued Program Budget Decision (PBD) No. 425 in December 1996 that stipulated that the Military Departments would be reimbursed \$66.5 million for FY 1996. For FY 1997, we issued a draft audit report in December 1997 that verified sales and obligations figures for FY 1997. Based on our draft report, the Deputy Comptroller issued PBD No. 425 in December 1997 that stipulated that the Military Departments would be reimbursed \$229.1 million for FY 1997, and estimated that they would be reimbursed \$114.6 million for FY 1998. See Appendix C for a summary of CIT reimbursements for FYs 1996, 1997, and 1998.

Objectives

The objective of this audit was to report the cash impact that the FY 1998 CIT, phase II, had on the Army, the Navy, the Air Force, and DLA supply management business areas of the Defense Working Capital fund. We also included a review of the management control program as it applied to the audit objectives. See Appendix A for a discussion of the scope, methodology, and management control program. See Appendix B for a summary of prior coverage.

Cash Reimbursements for Consumable Items Transferred

The DLA used an objective methodology to compute the cash reimbursement amounts due the Military Departments for the CIT, phase II, items transferred to DLA. The DLA based the reimbursement amounts on total sales less obligations incurred for phase II item stock replenishments. As a result of using the DLA methodology, the FY 1998 reimbursement to the Military Departments' supply management business areas of the Defense Working Capital fund was about \$285.1 million.

Military Department Methodology for Computing Cash Reimbursements

For FY 1996, the Deputy Comptroller (Program and Budget) requested the Military Departments to submit estimates on the cash impact that the CIT, phase II, would have on the supply management business area of their Defense Working Capital funds. Each Military Department computed cash reimbursements differently. The Army used anticipated cash outlays on vendor deliveries for outstanding orders on phase II items as the basis for computing the cash reimbursement amount. The Navy based its reimbursement estimate on projected sales that would be lost for those items that would be transferred to DLA. The Air Force used the value of lost sales and included disbursements for CIT, phase II, items that were on order at the time of transfer. As discussed in Inspector General, DoD, Report No. 97-106, none of the Military Department methodologies objectively computed the reimbursement amounts.

DLA Methodology for Computing Cash Reimbursements

The DLA devised an objective method to compute the cash reimbursement amounts due the Military Departments for the CIT, phase II, items transferred to DLA. DLA developed a methodology to obtain the actual cash impact of the CIT, phase II. Actual sales were totaled for FY 1996; and the FY 1996 obligations that DLA incurred during FY 1996 to replenish inventory were subtracted to compute the net reimbursement amount. In Report No. 97-106, we recommended, and the Deputy Comptroller agreed, that the DLA methodology be used for the FY 1996 reimbursements and for reimbursements for the remainder of the CIT, phase II, transfer.

Audit Verification of DLA Calculations

FY 1998 Reimbursement Amount. Using the DLA methodology, we determined that the reimbursement amount of \$285.1 million was appropriate for FY 1998. Based on the September 30, 1998, sales and obligations amounts that DLA accumulated, reimbursement to the Military Departments for FY 1998 would total about \$285.1 million, which is the net amount of \$759.2 million in sales less \$474.1 million in obligations. The table below shows the reimbursement amounts for each Military Department. The total amount of reimbursements is about \$171 million more than the Deputy Comptroller estimated in the December 1997 PBD No. 425.

DLA Calculations and Deputy Comptroller Estimates for FY 1998 CIT, Phase II, Reimbursement Amounts (millions)

<u>Military Department</u>	<u>DLA Calculations</u>	<u>Deputy Comptroller Estimates</u>	<u>Difference</u>
Army	\$ 36.4	\$ 20.8	\$ 15.6
Navy	107.6*	38.4	69.2
Air Force	<u>141.1</u>	<u>55.4</u>	<u>85.7</u>
Total	\$285.1	\$114.6	\$170.5

*Includes about \$1 million for the Marine Corps.

The DLA amounts are supported by individual sales and obligations for each item transferred. The sales data can be tracked to actual document numbers for requisitions that customers submitted to DLA ICPs. The obligations data can be tracked to the contracts that DLA awarded to replenish inventory. For FYs 1996, 1997, and 1998 the Deputy Comptroller provided about \$573 million in cash reimbursements to satisfy the cash imbalance issue caused by the CIT, phase II. The \$573 million is about \$32 million more than the \$541 million cash imbalance that the Military Departments estimated for the CIT, phase II (see Appendix C).

Accuracy of Reimbursement Amount. To verify the accuracy of the DLA reimbursement amount, we reviewed the sales and obligations data (for a judgmental sample, stratified by Military Department) of 300 CIT, phase II, items that were accumulated in the DLA Standard Automated Materiel Management System at three DLA ICPs. We reviewed about \$152 million (20 percent of the \$759.2 million) in sales revenues and about \$71.4 million (15.1 percent of the \$474.1 million) in contractual obligations that the three DLA ICPs incurred during FY 1998. The actual sales amounts that the DLA ICPs recorded agreed with the sales and obligations amounts that the DLA Comptroller recorded for the 300 items reviewed. We verified that \$152 million in actual sales agreed with the

amounts the DLA Comptroller recorded. Our test of 300 items included 93 items with obligations valued at about \$71.4 million. We verified that \$71.4 million agreed with the amounts the DLA Comptroller recorded.

Conclusion

DLA used an objective methodology to compute the reimbursement amounts for the CIT, phase II, items. Based on the items tested, the \$285.1 million reimbursement amount that DLA calculated for items transferred in FY 1998 was appropriate.

Appendix A. Audit Process

Scope

We reviewed the process that DLA used to compute the estimated cash reimbursement amounts to be given to the Military Departments as a result of CIT, phase II. We reviewed accounting reports and item transaction history reports for FY 1998. We reviewed the procedure that DLA used to gather FY 1998 sales and obligations data for CIT, phase II, items. We also followed up on the corrective action that DLA took regarding the recalculation of the FY 1997 reimbursement amount on CIT, phase II, items that were retransferred between DLA ICPs after their initial transfer from the Military Departments.

DoD-wide Corporate Level Goals. In response to the Government Performance Results Act, DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

Objective: Fundamentally reengineer DoD and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

Logistics Functional Area. Objective: Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). **(LOG-3.1)**

High Risk Area. The General Accounting Office has identified several high risk areas in the DoD. This report provides coverage of the Defense Inventory Management high-risk area.

Methodology

We reviewed FY 1998 sales and obligations data for a judgmental sample, stratified by Military Department, of 300 CIT, phase II, items that had been transferred to DLA. Our sample was selected from a universe of 134,156 items that had been transferred as of May 1998, and included those items that had the highest demand values for the 12 months preceding the transfer to DLA (see Table A). The 300 sampled items represented \$255.1 million of the \$711.7 million in annual demand value that was attributable to the universe of 134,156 CIT, phase II, items. We compared the actual sales and obligations data that were recorded at three DLA ICPs (Defense Industrial Supply Center, Philadelphia, Pennsylvania; Defense Supply Center Columbus, Columbus, Ohio; and Defense Supply Center Richmond, Richmond, Virginia) to similar data that the DLA Comptroller accumulated in an effort to determine amounts to be reimbursed to the Military Departments as a result of CIT, phase II, transfers. As of May 1998, the management of 134,156 of a planned 150,866 phase II consumable items had been transferred from the Military Departments to DLA.

Table A. Transfer of Consumable Items

<u>Military Department</u>	<u>Items Scheduled to be Transferred</u>	<u>Items Transferred</u>	<u>Items Sampled</u>
Army	19,593	15,900	46
Navy	35,628	32,380	78
Air Force	<u>95,645</u>	<u>85,876</u>	<u>176</u>
Total	150,866	134,156	300

Use of Computer-Processed Data. We verified information sampled from the DLA Standard Automated Materiel Management System database maintained by DLA for items transferred from the ICPs of the Military Departments, and from the database of sales and obligations maintained by the DLA Comptroller for CIT, phase II, items. Data tests showed that records in each database were reliable. We made no independent assessments of the reliability of computer-processed data other than that used in the audit.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from May through October 1998 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD. Further details are available on request.

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provide reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of Management Control Program. We reviewed the adequacy of the DLA management controls over the CIT, phase II, as they related to the methodology DLA used to determine the cash reimbursement amounts for the Military Departments' supply management business areas of the Defense Working Capital fund. We did not assess the adequacy of management's self-evaluation.

Adequacy of Management Controls. The DLA management controls we reviewed were adequate in that we identified no material management control weaknesses.

Appendix B. Summary of Prior Coverage

During the past 5 years, the Inspector General, DoD, performed four audits of the CIT. One audit covered the overall management of the CIT, phase I, item transfers and one covered the overall management of the CIT, phase II, item transfers. The remaining two audits dealt with the cash impact of the CIT, phase II, transfers for FYs 1997 and 1998.

Inspector General, DoD, Report No. 98-071, "Cash Impact of the Consumable Item Transfer, Phase II, FY 1997," February 11, 1998

Inspector General, DoD, Report No. 97-226, "Consumable Item Transfer, Phase II, Management," September 30, 1997

Inspector General, DoD, Report No. 97-106, "Consumable Item Transfer, Phase II, Cash Imbalance Issue," March 5, 1997

Inspector General, DoD, Report No. 94-071, "Transfer of the Management of Consumable Items to the Defense Logistics Agency," March 31, 1994

Appendix C. Summary of CIT, Phase II, Reimbursements

Items Transferred Between DLA ICPs During FY 1997

During FY 1997, as part of the 1990 Commission on Defense Base Closure and Realignment Act, DLA transferred groups of national stock numbers, known as Federal stock classes, between the three remaining DLA ICPs. In Inspector General, DoD, Report No. 97-071, we determined that the DLA methodology for tracking CIT, phase II, sales and obligations did not consider sales and obligations for items transferred between two DLA ICPs after the initial transfer from the respective Military Department ICP. Our sample of 300 items included 4 items that had been retransferred during FY 1997. We noted that the DLA Comptroller did not consider \$3.4 million in sales and \$2.4 million in obligations, for a net difference of \$1 million in reimbursements due the Military Departments. We did not determine the total number of CIT, phase II, items that DLA transferred during FY 1997. However, we recommended that DLA determine the additional sales and obligations attributable to the CIT, phase II, items that were transferred between the DLA ICPs during FY 1997, so appropriate adjustments could be made to the FY 1997 reimbursements due the Military Departments. During FY 1998, DLA implemented a systems change that corrected the problem in accounting for sales and obligations for items retransferred between the DLA ICPs. Based on a recalculation of FY 1997 amounts, DLA determined that the total reimbursement amount should have been \$221.2 million or \$7.9 million less than the \$229.1 million that was reimbursed. The decrease occurred because more obligations were not considered than sales that were not considered. The \$7.9 million was broken out as Army, \$5.8 million; Navy, (\$4.6 million); and Air Force, (\$9.1million). The Deputy Comptroller will address the required adjustments for the FY 1997 reimbursements in the December 1998 PBD No. 425.

Cash Reimbursements for FYs 1996, 1997, and 1998

The Military Departments received \$572.8 million of cash reimbursements for the CIT, phase II. The Military Departments' original estimates of the CIT, phase II, cash shortfall was \$540.5 million. Cash reimbursements provided by the Deputy Comptroller for FYs 1996, 1997, and 1998, was \$572.8 million, or \$32.3 million more than the original estimates. Table C shows the cash reimbursements that were made to each Military Department.

Table C. Amounts Reimbursed to the Military Departments
(millions)

<u>Military Department</u>	<u>Military Department Estimate</u>	<u>Amount Reimbursed</u>	<u>Difference</u>
Army	\$166.0	\$98.3	\$(67.7)
Navy	153.7	204.2 ¹	50.5
Air Force	<u>220.8</u>	<u>270.3</u>	<u>49.5</u>
Total	\$540.5	\$572.8²	\$32.3

¹Includes about \$5 million for the Marine Corps.

²Includes total adjustments of (\$7.9 million): Army, \$5.8 million; Navy, (\$4.6 million); and Air Force, (\$9.1million).

Appendix D. Report Distribution

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Audit Team Members

This report was prepared by the Readiness and Logistics Support Directorate,
Office of the Assistant Inspector General for Auditing, DoD.

Shelton R. Young
Raymond D. Kidd
Tilghman A. Schraden
Alexander L. McKay
Janice Conte
Herman Tolbert